Switzer Super Report

Thursday 5 November 2015

Big spender

Well the Reserve Bank decided to leave the cash rate on hold at 2% earlier this week. I wasn't happy with the decision, but the RBA says business surveys suggest economic conditions are gradually improving. Charlie Aitken explains today why we need to see more business spending and investment, and shares a company to have a look at.

Also in the *Switzer Super Report*, Tony Featherstone surveys the small- and mid-cap industrials sector and reveals five stocks for the patient investor, who buys during market pullbacks.

Paul Kasian from Equity Trustees explains why he likes the Commonwealth Bank in this week's *Fundies Favourite*. And in *Buy, Sell, Hold – what the brokers say*, brokers upgraded Panoramic Resources, but downgraded Tatts Group. Plus, in *Questions of the Week*, we answer reader queries about the Macquarie share purchase plan, as well as the rules around franking credits.

Sincerely,

Peter Switzer

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Look for growth companies

by Charlie Aitken

Dear readers,

Firstly, let me apologise for not being able to write a note for the *Switzer Super Report* last week. I blame the United Kingdom's woeful telecommunications system, which wouldn't allow me to send an email from my iPhone!

As Australians, we all take for granted fast and reliable mobile voice, text and data service. That is even more so with Telstra's 4G network and the NBN being rolled out. When you travel to the UK, even just outside of London, you could easily believe you have time travelled back 20 years in terms of mobile coverage. I hadn't even seen the words 'GPRS' on my screen for as long as I can remember!

We live in an increasingly digital world and digital economy. I'd have to say I though the UK's telecommunications were third world and actually made me concerned about overall investing in the UK. All economies need up-to-date infrastructure and Australia's is getting more up-to-date in many areas. This is a good thing for Australia's future growth and productivity.

On that topic, it was encouraging to receive many positive replies to my email, following a recent dinner with the new Prime Minister, Malcolm Turnbull.

My analogy of the Australian economy as a "company", and the PM as the CEO, appears to have resonated strongly with readers.

A common characteristic of all good companies is strong leadership. It's clear that the PM's strong corporate pedigree sits well with the electorate. The prime example is the most recent Newspoll survey, which revealed that Malcolm Turnbull's approval rating has soared to a four-year high for any PM. In addition, 67% of respondents currently believe that he is the preferred PM.

While I usually don't look at political polls, the Nation is crying out for decisive direction and strong leadership and it appears the PM is attracting support from both sides of politics. This is a good development for the economy and business. It's also pleasing to see that the Opposition's attempts to re-ignite the class warfare debate, by highlighting the PM's wealth and Cayman Island investments, failed to gain any traction with voters.

In contrast, many obviously see the PM's business success as aspirational for fellow Australians. I perceive a positive change and a sense of optimism in the community and it seems like a veil of pervasive negativity has lifted after seven long years of combative, negative politics.

The PM's positive approval rating is also being reflected by a marked change in business sentiment.

NAB's September Quarter business confidence survey revealed that corporates viewed the current conditions as the strongest since 2008. Lending to businesses surged in September, registering the strongest growth in the post GFC period. According to RBA figures, business credit rose 1.2% versus an average monthly gain of just 0.1% for the last seven months. This has translated to credit growth of 6.87% per annum, or the fastest growth since February 2009.

There is no doubt that economic rebalancing following the end of the mining boom remains dependent on a resurgence in business spending by corporate Australia. In this regard, the disastrous future cap-expenditure intention surveys over the last 12 months have highlighted the business investment cliff for the economy. At the same time, the lack of investment in future growth by corporate Australia has directly correlated to a lack of confidence in governments.

The good news is that consumer and business confidence is recovering but we still await the return of the "animal spirits", which drive spending, investment and productivity. However, at the RBA meeting this week, the Board decided to leave rates unchanged, due to a belief that "business surveys suggest a gradual improvement in economic conditions."

As I mentioned in my last article, "for the economy to grow you need the Federal Government, State Governments, the RBA, listed corporates and consumers all effectively spending". In recent meetings and media presentations, the PM has continually stressed the government's commitment to infrastructure spending. Meanwhile, the government has approved an increase in Fed funding for the next stage of the Gold Coast light rail project.

The importance of the government's role in infrastructure investment has encouraged bipartisan support, with the Opposition pledging a $10b contribution to the Infrastructure Australia fund. This represents a major step forward for both economic rebalancing and stronger domestic growth.

I believe Australia is on the cusp of a major private/public infrastructure revival.

While I will always advocate fully franked dividend yield for any balanced portfolio aimed at generating long term wealth, I believe ASX 200 dividend payout ratios averaging over 70%, are close to peaking. Conversely, I believe we remain in the early stages of a corporate re-investment in growth.

This trend change has important implications for the composition of ASX performance. As such, I expect an increase in PE-dispersion, where growth stocks outperform yield plays and companies with improved growth prospects attract higher PE multiples. A prime example is Vitaco (VIT), which remains a core long-term portfolio position.

Vitaco (VIT)

***Source**: Yahoo!7 Finance, 5 November 2015*

Recently, I highlighted ASX listed companies, which are currently being rewarded by higher PEs for GROWTH initiatives, which include Macquarie Group (MQG), Treasury Wine Estates (TWE), Servcorp (SRV), & Domino's (DMP). This is the start of a trend in my view where GROWTH will outperform YIELD. The composition of our portfolio is now reflecting a new "search for growth" strategy.

In line with my view of a resurgence in business spending, I believe Qube Holdings (QUB) will benefit from my expectation that we are entering a strong public and private infrastructure investment cycle. Qube Holdings is a diversified logistics and infrastructure company that provides a diverse range of integrated port services, bulk material handling and bulk haulage. The Chairman is Chris Corrigan, the ex CEO of Patricks, which was taken over by Toll Holdings with the Patrick assets eventually spun out into Asciano (AIO).

Qube Holdings (QUB)

***Source**: Yahoo!7 Finance, 5 November 2015*

In partnership with Global Infrastructure Partners (GIP) and Canada Pension Plan Investment Board (CPPIB), the consortium recently bought 19.9% of the voting control of Asciano. The purchase represents a blocking stake in Brookfield's Infrastructure Partner's scheme of arrangement offer for Asciano, which effectively kills the takeover offer, while providing QUB the opportunity of a seat at the table for any possible asset breakup.

The prize for QUB is the port assets or Patrick's stevedoring business including four capital city container terminals. A purchase of the port assets would be transformational, doubling the size of the merged company and providing QUB control of the logistics supply chain, from container loading to distribution via a rail network to the newly approved Moorebank intermodal terminal, which has the ability to handle nearly half of Port Botany's existing 2.3m container traffic. Clearly, it's early days, but QUB has already soared on the expectation of a deal for Asciano's port assets. In partnership, GIP and CPPIB would share the Pacific National rail assets.

Big overseas infrastructure funds are circling Australian assets. With a new player entering the Asciano takeover, the price for infrastructure and growth assets has just risen significantly. Once again, I believe that the economy is entering a strong business spending and infrastructure investment cycle in which growth assets will attract a significant PE premium as the economy rebalances.

I encourage you to have a look at QUBE (QUB). This is a mid-sized company that started as a small company that could be about to become a very big company controlling very strategic, high barrier to entry assets. As the company could be completely different in a few months' time, there's no reason to analyse current QUB earnings. This really comes down to back successful management with an ambitious growth agenda.

I continue to encourage you to increase weightings in growth companies as the Australian economy comes out of the doldrums.

My AIM Global High Conviction Fund fund has moved that way to growth and that is one key reason we have beaten the ASX200 by 11.1% in just three months.

Patience game: five small- or mid-cap industrials

by Tony Featherstone

Finding bargains in small-cap land is getting harder. As large-cap fund managers look further down the market for value, many small-cap industrials have been re-rated. But there are opportunities for patient investors who buy during market pullbacks.

The five stocks below were chosen for different reasons. Online educator 3P Learning makes the grade because it looks undervalued. So does litigation funder IMF Bentham after case losses crunched its share price.

Spotless Group Holdings also looks a touch undervalued and its defensive qualities appeal in a volatile market. Veterinary group Greencross appeals after shedding a third of its price. DuluxGroup rounds out the list because its long-term strategic appeal is undervalued.

Here is an overview of the five small- or mid-cap industrial stocks:

1. 3P Learning

The education software firm continues to frustrate investors. It has traits of exceptional companies: low debt, high return on equity, high margins, recurring revenue, a genuine global footprint and good management. It also has fabulous products in Mathletics, used by more than 3 million students worldwide, and Reading Eggs, which it distributes.

But the share price has disappointed. 3PL listed on ASX in July 2014 through a $282 million Initial Public Offering (IPO) at $2.50 a share, in a heavily oversubscribed offer. It briefly traded above the issue in May this year, before slumping to $1.80 as the share market sell-off peaked in September. It is now $2.30.

3PL initially beat prospectus forecasts and its latest earnings result bettered market expectations. Some fund managers are concerned that it is discounting products to gain traction in the US, and its recent acquisitions might have spooked investors.

3PL acquired in September a 23% shareholding in Learnosity Holdings, a Dublin-based provider of software-as-a-service assessment tools for US$19.4 million. That followed its US$5 million investment in March for a 17% stake in Desmos Inc, a US graphic calculator application business.

At $2.30, 3PL trades on a forecast Price Earnings (PE) multiple of 20 times 2015-16 earnings, based on a small number of analysts who cover the stock. That is lower than several software stocks that are not nearly as established or growing as rapidly overseas. Macquarie Equities Research has a 12-month price target of $2.92. 3PL is one to watch.

3P Learning (3PL)

***Source**: Yahoo!7 Finance, 5 November 2015*

2. IMF Bentham

The litigation funder soared from $1.60 in February 2014 to $2.47 a year later. Its descent was just as swift: IMF hit $1.34 last month.

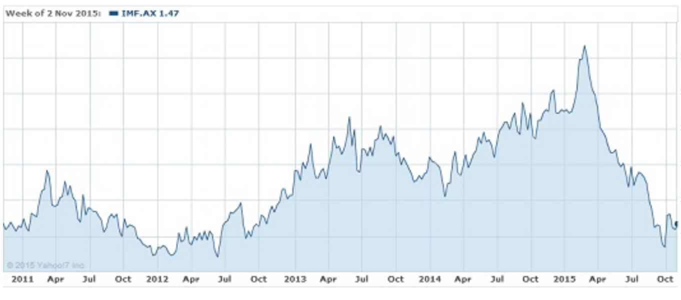
To recap, IMF funds shareholder and consumer class actions – a growing area of legal claims in Australia and offshore. It is a bit like a funds-management business: IMF backs a portfolio of cases, each with different expected settlement timeframes, and spreads risks. It typically earns about 30% of cases settled before trial, sometimes more.

IMF has lost only 6% of cases backed over the 14 years, but four case losses, rare by its standards, was enough to smash the share price. Its portfolio of 39 cases at 30 June 2015 had an estimated claim value of about $2 billion (of which IMF would take a share if all of them were successful). Assuming its long-term case-win rate resumes, IMF looks undervalued.

IMF had $130 million in cash on the balance sheet at June 30, 2015– high for a company capitalised at $246 million. It trades on a forecast PE of about seven times 2015-16 earnings. Four analysts who cover it have a buy recommendation and the median price target is $2.41.

IMF's earnings and revenue can be lumpy, and litigation funding is a high-stakes game. But it operates in a long-term growth industry as more class actions are pursued, is the dominant litigation funder in Australia, and is growing overseas. IMF is also consistently well run.

IFM Bentham (IMF)



***Source**: Yahoo!7 Finance, 5 November 2015*

3. Spotless Group Holdings

As more companies target high-growth tech markets, Spotless is making solid gains in cleaning and catering. Neither industry is glamorous, but they give Spotless a vital commodity in a volatile market: defensive, visible earnings growth.

Much has been achieved since Private Equity Partners bought the struggling Spotless in 2012, delisted it from ASX, and fixed it. It came back to market in May 2014 through an IPO that raised $994 million at $1.60 a share. Spotless is now $2.13.

Spotless' maiden full-year result, released in late August, beat revenue and earnings (EBITDA) forecasts in the prospectus by 5-6%. Its profit margins in the Health, Education and Government division bettered market expectation.

Spotless has announced several contract wins or renewals this financial year and looks well placed in the booming healthcare and aged-care sector. The market is underestimating the company's potential to provide outsourced facility, laundry and linen services to sectors benefiting from huge demographic tailwinds.

Most brokers who cover Spotless have a buy recommendation, but a target price of $2.25, based on a small consensus of brokers, suggests it is fully valued for now.

Spotless can do better than the market expects, buoyed by its healthcare division, contract wins, efficiency gains, and a management team that is driving plenty of operational momentum. A 4-5% expected yield is another attraction.

Spotless Group Holdings (SPO)

***Source**: Yahoo!7 Finance, 5 November 2015*

4. Greencross

The market could not get enough of the veterinary practice and pet-store owner. It soared from $1 in August 2011 to $10.17 in September 2014 as investors applauded its strategy to consolidate the fragmented veterinary industry through acquisitions.

But Greencross was hammered after Jeff David's surprise resignation as CEO in August, and amid market fears of rising competition in the veterinary industry. National Veterinary Care's listing on ASX in late July and talk that private equity firms are preparing to roll up practices suggests Greencross might have to pay more to buy assets.

Greencross was always due for a significant pullback after "ten bagger" gains, and I suspect the market had trouble digesting a spate of large acquisitions and its transformation in 2013 into a pet-store owner through the merger with the impressive Petbarn chain.

The acquisition provides cross-selling opportunities between veterinary services and pet goods, demand for which is expected to rise as people spend more on their animals.

The results are starting to show. Greencross delivered a solid 2014-15 result, said it had a positive trading start to this financial year, and that it expected to deliver strong organic-led growth in 2015-16. Bigger benefits from the merger should flow this year.

Seven of nine brokers who cover Greencross have a buy recommendation and the consensus price target is $8.32, analyst forecasts show. That looks a touch bullish for now. But after a period of share-price consolidation, Greencross can grow faster than the market expects.

Greencross (GXL)

***Source**: Yahoo!7 Finance, 5 November 2015*

5. DuluxGroup

Australia's leading paint maker, and one of the market's higher-quality mid-cap stocks, is approaching value territory after falling from a 52-week high of $6.88 to $5.88.

Fears that big retailers could sell more private-label paint and reduce DuluxGroup's shelf space have weighed on the stock. So have concerns of price discounting and irrational market behaviour in low-end paint and more competition from multinationals in the high-end area.

But these fears look overstated. Dulux paint, increasingly fashionable, is a drawcard for its key distribution channel, Bunnings. Dulux backed the right horse in 2013 when it pulled its paint and wood-care products from Woolworths' Masters chain and concentrated on Bunnings.

Dulux has a strong position in an oligopoly for paint and has cleverly positioned itself at the higher end. Key brands such as Antique White USA are popular among home renovators and a reason why they prefer premium over discount paints.

The home-improvement market shows no signs of slowing as high house prices encourage more people to stay put and renovate, rather than move. Record-low interest rates are another driver of sustained growth in the renovations and refit market. Moreover, Bunnings has plenty of growth ahead of it and Dulux should benefit as the hardware chain extends its lead.

Three of 11 analysts who cover Dulux have a buy recommendation, six a hold, and two have a sell. A median price target of $6.10 suggests Dulux is fully valued for now. The market is underestimating the changing nature of the paint market, as renovators favour premium brands, and Dulux's potential to drive stronger performance from its Alesco-acquired assets.

Dulux's exposure to the renovations markets also means it is less volatile than its peers that rely on the more cyclical housing starts, although the Alesco Corporation acquisition in 2013, with its garage doors and building products, added an element of higher cyclicality to the company's earnings.

DuluxGroup (DLX)

***Source**: Yahoo!7 Finance, 5 November 2015*

– Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at 5 Nov 2015.

***Important**: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Strong domestic bank: CBA

by Paul Kasian

What is your professional pick?

Commonwealth Bank Australia (CBA).

Market Cap $130 billion.

How long have you held the stock?

We have been a long-term holder of the stock.

What do you like about it?

CBA remains the strongest domestic bank benefitting from its strong capital base, dominant market position, low funding costs due to its strong deposit base and significant exposure to low capital intensity assets (residential mortgages) allowing it to generate the highest return on equity (ROE) of the domestic banks.

This also results in CBA having strong organic capital generation capabilities, allowing it to meet any future capital requirements more easily and continue to maintain its dividend.

CBA is trading on a 14 times forward price to earnings multiple and an 8% forward grossed up dividend yield.

How is it better than its competitors?

As stated above, CBA is the strongest domestic bank benefitting from its leading market share position across total lending and deposit markets only conceding market share in the corporate lending market.

This allows CBA to lead on pricing, as it operates in a disciplined oligopoly, and has access to the lowest cost of funding given its large proportion of low cost deposit accounts.

Despite recent changes by APRA to mortgage risk weights, CBA (and the majors) still has a capital advantage over standardised banks.

What do you like about its management?

CBA has a well-balanced senior management team that remains focused on its domestic business and maximising the returns of these assets through superior execution.

CBA has successfully invested in its technology systems, leading to continued productive gains and it remains well placed to defend future competitive threats.

What is your target price on CBA?

Around $81 in the next 12 months.

At what point would you sell it?

We will look to review our position if there were indicators that a bad and doubtful cycle was to materially trend upwards and any potential changes in regulatory capital requirements.

How much has it added (subtracted) to your overall portfolio over the last 12 months?

CBA has outperformed the broader ASX 200 Accumulation benchmark by 1.2% over the past year.

Commonwealth Bank of Australia (CBA)

***Source**: Yahoo!7 Finance, 5 November 2015*

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Citi has upgraded Alumina (AWC) to Neutral from Sell while reducing the price target to $1.15 from $1.20 as the analysts incorporate the decision made by JV partner Alcoa to curtail alumina capacity further at Point Comfort.

The analysts hold a positive view on alumina prices post 2018, so this decision is poised to be reversed in the years ahead, if Citi forecasts prove correct. The decision to upgrade was made on the basis of "valuation" as the share price has been weak recently.

Macquarie has upgraded Panoramic Resources (PAN) to Outperform from Neutral. The September quarter was a tough one for Panoramic, Macquarie notes, given redundancy costs, provisional pricing adjustments and unfavourable shipment timing. But with the high-cost Lanfranchi mine now closed, the company should run close to cash flow break-even. The longer-term outlook is nevertheless excellent, Macquarie believes, as production increases from the Savannah North and Lower Schmitz projects.

In the not-so-good books

Macquarie has downgraded Amaysim (AYS) to Neutral from Outperform. On the back of its renewed wholesale contract with Optus, Amaysim has offered new phone plans which improve the company's competitive offering, Macquarie notes, but will place some pressure on revenues per user.

Leveraging off Optus is a key strategic plank for amaysim, the broker suggests, but the environment is becoming more competitive. Given recent stock price strength Macquarie pulls back to Neutral. Target unchanged at $2.45.

Macquarie has downgraded Buru Energy (BRU) to Neutral from Outperform. Macquarie observes many mid-cap energy companies have enjoyed a share price rebound from August lows and do not offer compelling valuation. The broker downgrades its recommendation to Neutral from Outperform and the target to 40c.

Deutsche Bank has downgraded Graincorp (GNC) to Hold from Buy. The pre-release of the FY15 result is considered a negative by Deutsche Bank, as it is at the lower end of guidance and misses the broker's forecasts. The weak result is primarily driven by an earnings loss in marketing. Deutsche Bank's FY16 forecasts are reduced by 18%. Rating is downgraded to Hold from Buy.

Macquarie has downgraded GWA (GWA) to Underperform from Neutral. GWA saw 3% sales growth in the September quarter but the company has warned the lower currency will drag on earnings in FY16. While the outlook for housing completions remains strong, the risk is whether GWA can pass on the currency impact to customers through higher prices, Macquarie notes.

Asset sales mean a second capital return is possible and GWA will recommence dividends in FY16, but on earnings risk the broker downgrades to Underperform.

Citi has downgraded Oceanagold (OGC) to Neutral from Buy. Citi analysts point at the strong share price appreciation to justify the downgrade in rating to Neutral from Buy. The analysts note there is upside in the company's exploration and resource drilling programs at its new projects.

Credit Suisse has downgraded Tatts Group to Underperform from Neutral. Credit Suisse downgrades to Underperform from Neutral, given the share price appreciation recently. The broker suspects turnover may be growing faster than revenue, largely because Tatts is increasingly promoting with free bets. The broker believes it is too early to judge whether UBET has traction with customers.

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Macquarie Bank and franking

by Questions of the Week

Question: Should we take up the Macquarie Bank share offer? Considering the share price was in the mid $70 range a couple of weeks ago, the offer price does not seem such a great deal.

Answer (by Paul Rickard):

Yes, you do need to take a view on Macquarie, and in that, consider recent trading history.

That said, Macquarie has been a real performer this year and their half year result surprised on the upside.

The shares under the share purchase plan are being offered at a price of $78.40 (effectively $80.00 on a comparable cum dividend basis). You are also protected on any immediate market downside in that you will pay no higher than $78.40 or the weighted average trading price (less a 1% discount) between 11 November and 17 November.

Notwithstanding it is no bargain, I think I would follow the lead of the institutional market and subject to cash needs, apply for the maximum amount ($10,000).

Question: I believe that you need to hold a stock for 47 days to receive franking. Does this mean 47 days before the stock goes ex div., or 47 days in total?

Also, I own some Genworth Mortgage. They paid an extra dividend a few months ago and I think they are doing a share buy back soon. To my mind, this shows really good financial health. Should this give me confidence for the future?

Answer (by Paul Rickard):

You need to hold the shares for at least 45 days. To get the dividend, you must own the shares on the day immediately before the day the stock goes ex dividend – apart from that, it is not specific as to whether it is 45 days in advance or arrears or some combination thereof – it must be at least 45 consecutive days (including the ex date).

With Genworth, the on-market buy back will help.

Sorry – not a fan of their business (or stock). Self-insurance options for the major banks, plus higher default rates as the property market takes a breather.

Don't miss this!

In this week's Super Session we review the month of October and reveal the best performing stocks.